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INSIGHT

MONTHLY COMMENTARY

April High Yield Credit Update

SIMON PARK & BRIAN GELFAND | MAY 10, 2016

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Mr. Park is a Managing Director in the U.S. Fixed Income group, where he trades high yield and cross over securities and CDS. Prior to joining TCW in 2015, Mr. Park was a portfolio manager and the fund risk manager for the hedge fund JAE Credit Management, focusing on U.S. corporate securities and derivatives Previously, Mr. Park was a Managing Director and portfolio manager in relative value corporate credit for the internal investment unit at UBS and its externally run hedge fund, Dillon Read Capital Management. Mr. Park started his career at Goldman Sachs and was a Managing Director focused on crossover credit on its corporate bond trading desk. Mr. Park earned his BA in Economics from Harvard College.

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Spring Fling

The Spring season has been upon us for two months now, and thoughts of rebirth and rejuvenation have made their way into the public consciousness after a brutal 2015 winter season (indeed, Los Angeles broke through the record of low 30s this year!). Gone are the days of plowing snow. Gone are the days of donning five layers of clothes, gloves, and a hat just to pick-up coffee down the street. Flowers begin to bloom. Children come out to play. The feelings of euphoria are infectious, as everyone around begin to enjoy themselves.

In his poem *Spring*, William Shakespeare portrays the cuckoo birds emerging in the springtime to mock married men. Spring is, and should be, most appreciated by the young and exuberant. Many fond memories are made during these glorious months, some of which include innocent, happy, yet brief encounters. The spring fling is one such encounter.

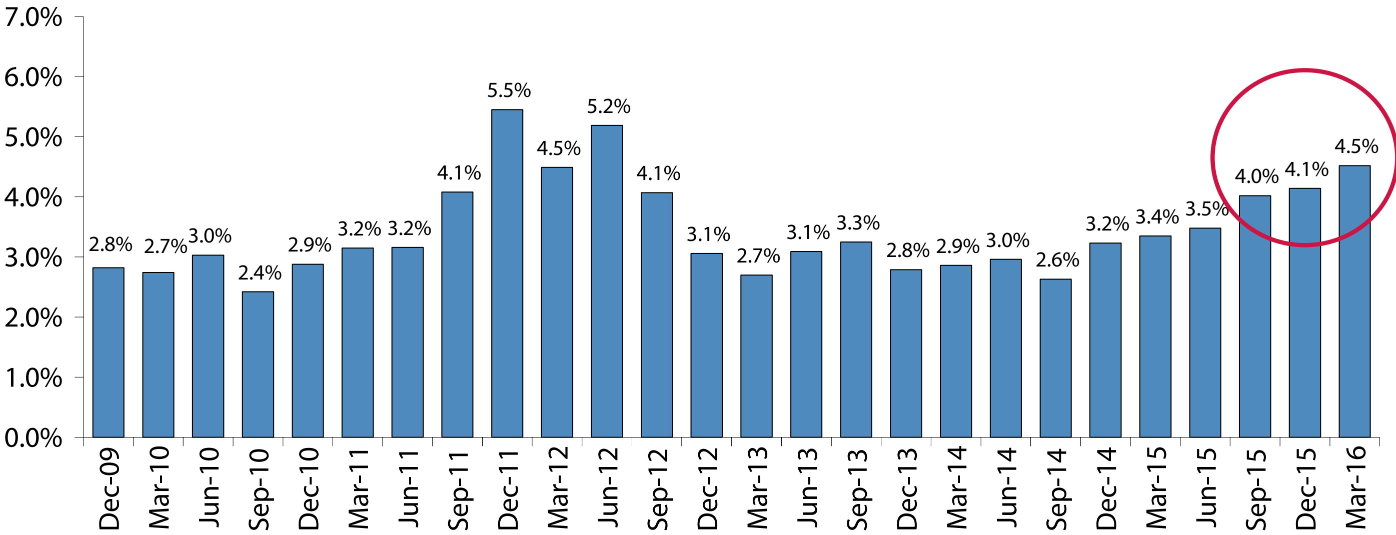
Memories of spring flings are generally good ones. But by definition, they are fleeting; brief romantic amusements, not long-term commitments.

Much like our former teenage selves, investors have recently been having their own version of a spring fling. Following fierce selling during the brutal cold of the fall and winter, hope has flooded into the hearts of investors. And as the chill thawed from their bones, they looked for new dalliances with formerly scorned securities, causing a violent bounce off of oversold conditions across risk asset classes.

	CY-14/15		CY-15/16	
	Fall/Winter	**Spring**	**Fall/Winter**	**Spring**
HY Spread Change	+171bps	-129bps	+303bps	-264bps
HY Spread %Change	47% Wider	23% Tighter	56% Wider	31% Tighter
WTI Crude Oil	-53%	41%	-46%	75%
S&P 500	-7.40%	14.39%	-13.28%	14.92%

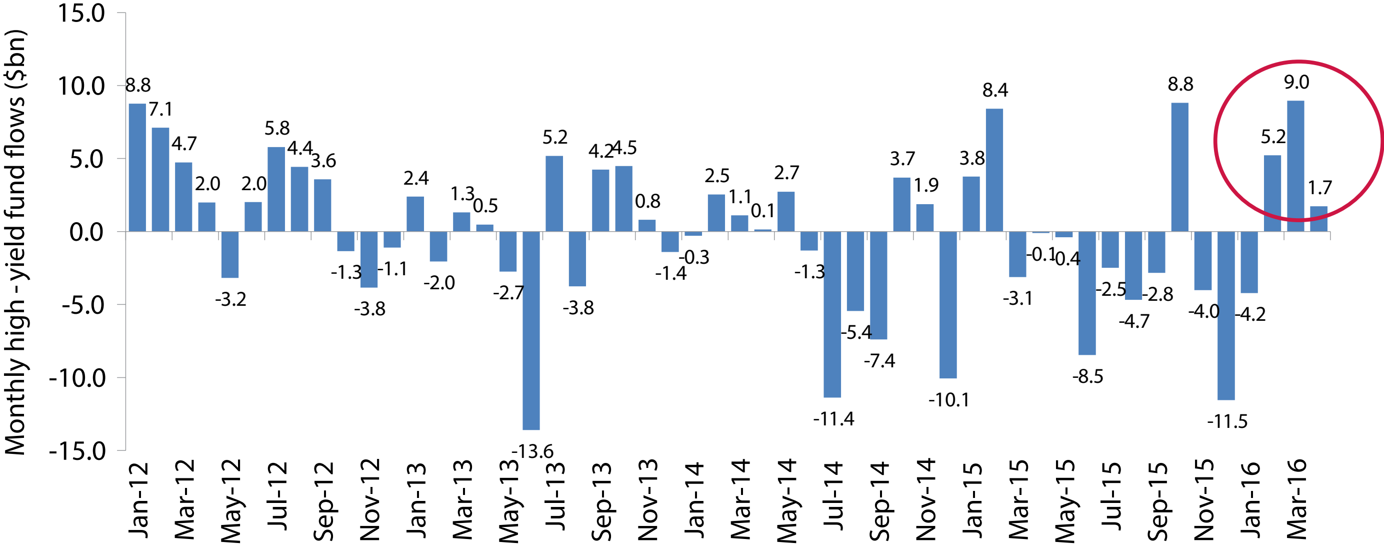
But like many spring flings, this does not extend from a feeling of true love, but rather a stirring with the season, infected by the joy of others. Quick and unexpected inflows into the HY asset class fueled the fire of this bear market rally, with managers focused on keeping flows and coupons invested, while not feeling confident enough to reduce outright cash levels without an all-clear signal. Moreover, a light primary calendar and low dealer inventories helped to compound the price movements in this chase for assets and yield.

HY Mutual Fund Cash Balances Continue to Ramp Q/Q...



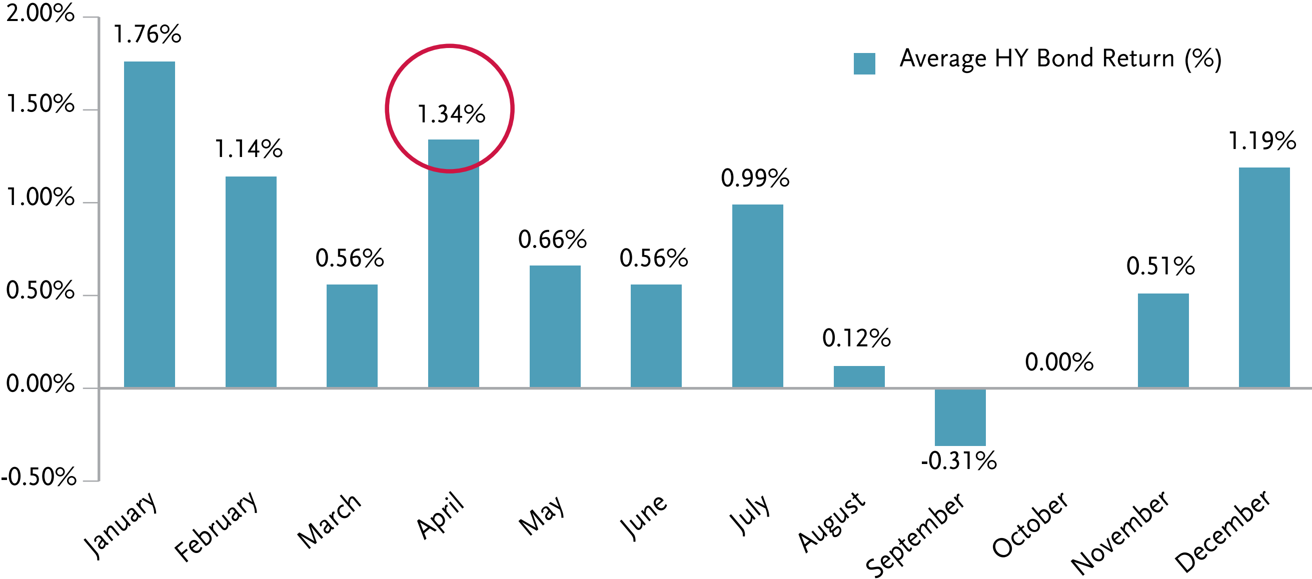
Source: JP Morgan

...As New Money Flocks to the Asset Class



Source: Lipper FMI

Sticking with the literary narrative, unlike in T.S. Eliot's world, April is not the cruelest month. Looking historically, outside the distinct January effect still experienced in the high yield market, April has seen the best returns of any month, while the subsequent periods have tended to be about average.

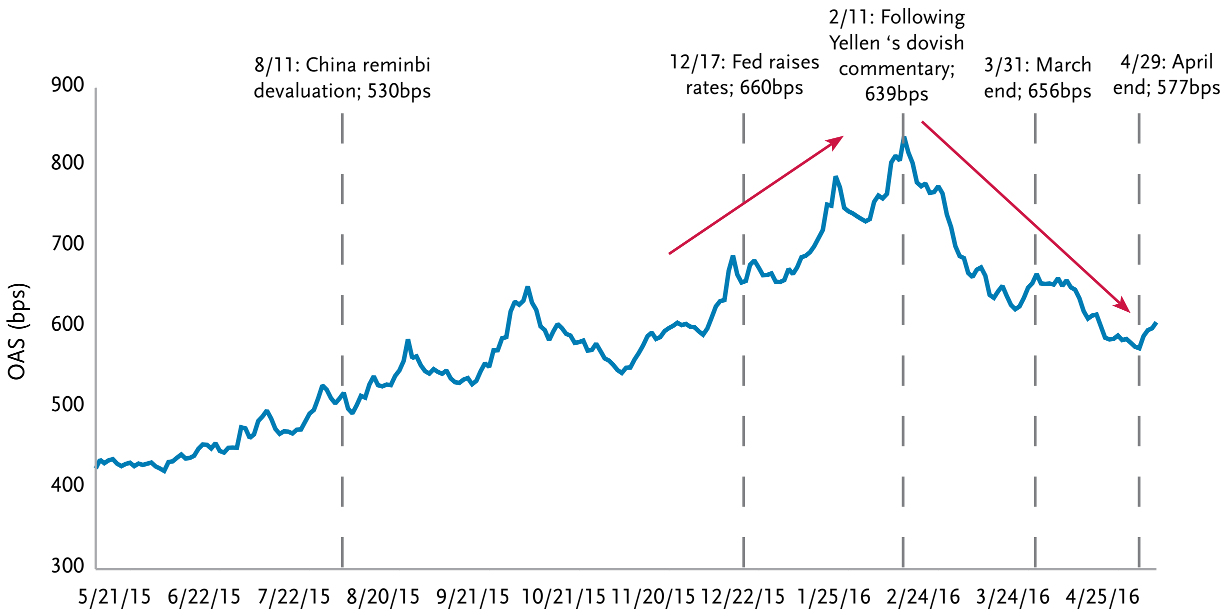


However, averages have little weight when looking over discrete periods, and after the Herculean run in the market since mid-February, much like a spring fling, sticking around too long could be awkward, underwhelming, and in some cases, turn a good memory into heartbreak.

Market Performance

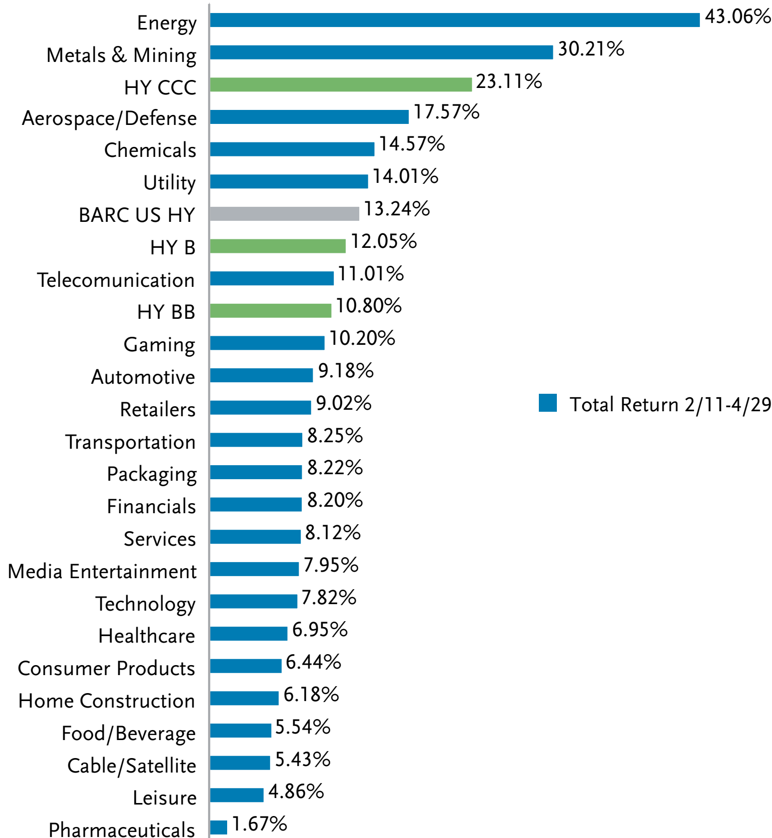
After a brief hiatus from the one-way trade in the last week of March, high yield bonds, in conjunction with risk assets broadly, extended their relentless "positioning" fueled rally for another four weeks in April. Commodity-linked sectors led the way for a second straight month, with Energy firmly assuming the reins as the confluence of rising crude prices (WTI futures gained +$7.58 to $45.92/bbl in April), highly supportive technicals, and high nominal yields, coaxed a pain bid from cash-rich, Energy-underweight investors. This has really been one for the record books, as both the magnitude and speed of the run since the February 11th wides have been breathtaking; consistent more with the momentum seen when emerging from a recessionary trough than during a late-cycle bounce. Putting some numbers around it, the Barclays U.S. HY Index is up +13.2% since the mid-February lows, erasing the losses from the first six weeks of the year, and the Energy and Metals & Mining sub-indices have posted enormous gains of +43.1% and +30.2%, respectively, over the same period.

High Yield Spreads Continued Lower In April, Benefiting From A Strong Technical Bid



Source: Barclays

Commodity-Linked and High Beta Credits Have Materially Outperformed Over the Last 11 Weeks

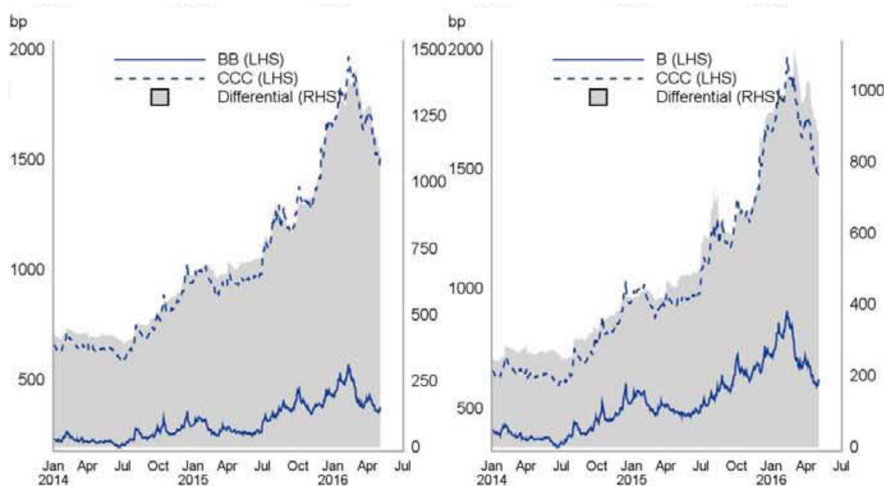


Source: Barclays

High Yield spreads tightened -79bps on the month with CCCs and Distressed (returning +7.8% and +17.8%, respectively) outpacing Bs and BBs (+3.8% and +2.6%, respectively), consistent with the risk compression one would expect as this mini-cycle matures. High Yield spreads are now -262bps inside the wides reached mid-February, a run which we note came largely absent a commensurate recovery in macro and corporate fundamentals.

HY Performance	HY	Ba	B	Caa	Ca-D
April 2016 Total Return	3.92%	2.56%	3.77%	7.78%	17.82%
2016 Total Return	7.40%	6.52%	6.31%	11.83%	23.33%
April 2016 OAS Chg	-79bps	-47bps	-82bps	-175bps	
2016 Excess Return	+485bps	+381bps	+381bps	+967bps	

Spreads Continued to Compress Across Risk Cohorts



Source: Goldman Sachs

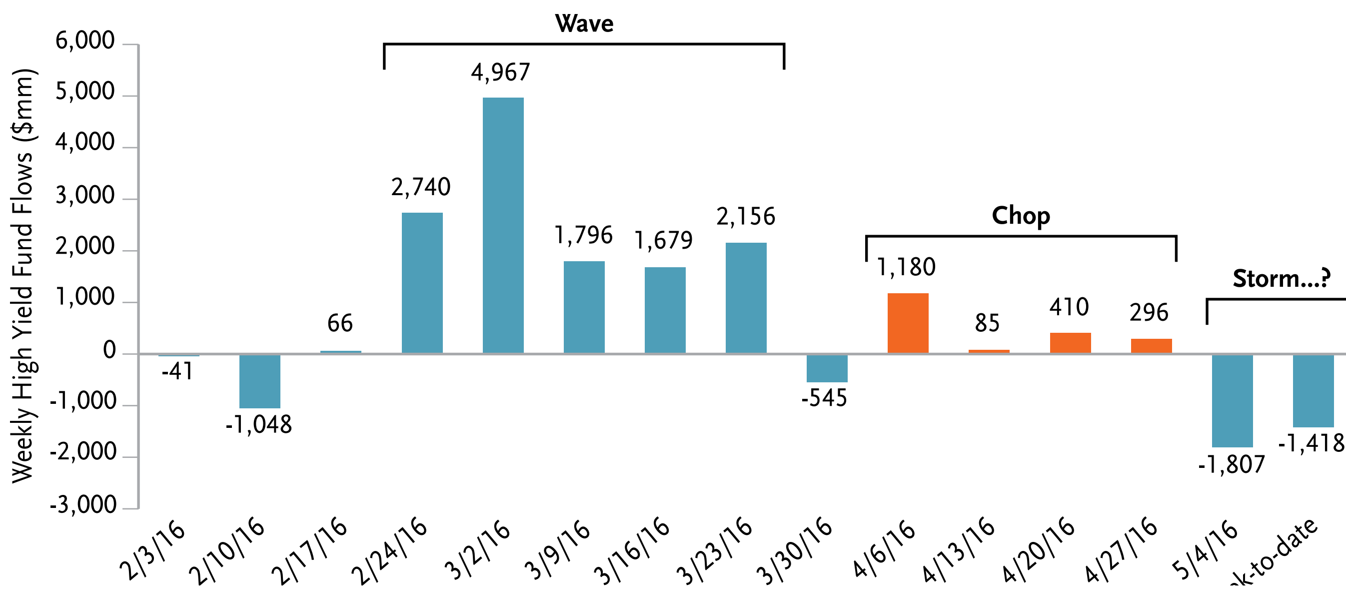
As was the case in March, all sectors generated positive returns in April, with the previously most beaten down corners of the market posting the strongest gains. Energy related credits were the clear standout again this month, outpacing Metals & Mining issuers which led in the early weeks of the rally. As alluded to above, while consensus projections for declining U.S. shale oil production and improving natural gas demand offered some fundamental rationale for the Energy gains, the strength of the rally in the sector in April was significantly influenced by a painfully underweight and underperforming investor base, reluctantly chasing risk in an attempt to catch up with a running market; a strategy we do not recommend trying at home.

Best Sectors	April	Previous 12 Months	Since 2/11/16
E&P	18.04%	-29.03%	63.19%
Oil Field Services	13.68%	-14.51%	40.04%
Metals & Mining	9.91%	-6.10%	30.21%
Midstream	7.09%	1.12%	25.61%
Aero/Defense	5.64%	2.29%	17.57%
Worst Sectors	**April**	**Previous 12 Months**	
Construction Machinery	0.83%	1.92%	
Refining	0.98%	-6.55%	
Environmental	1.07%	-28.11%	
Leisure	1.07%	2.69%	
Retailers	1.12%	1.90%	

Market Technicals

HY mutual funds, including ETFs, benefited from a third consecutive month of inflows in April, bringing the 3-month total to +$15.9bn and recouping ~80% of the -$19.8bn exodus from HY accounts during the prior 3-month period. April reported inflows totaling +$1.7bn, which while respectable, represented a significantly slower run-rate from last month's near-record setting +$9.0bn inflow. Moreover, a notable weakening in ETF flow momentum in the final week of April (and the first week of May) may be offering an early signal of the beta trade losing steam.

3rd Consecutive Month of Inflows, Though the Momentum Appears to Be Losing Steam



Sources: Lipper; J.P Morgan

On the supply side, the primary market was active in April as more favorable market conditions both permitted and incentivized issuers to take advantage of the window of opportunity to address their capital needs. U.S. HY new issue volumes reached a respectable $31.2bn in April, building on the momentum from March and representing the fourth straight month of volume growth after one of the slowest starts to a year on record. High quality issuers were met with near insatiable demand for paper, permitting syndicate desks to clear upsized deals at prices well through initial price talk. More notable, however, was the return of issuers to which just two months ago the primary markets were completely shuttered (i.e. CCCs and commodity-linked issuers). CCC-rated paper constituted 12% of new issue volume for the month, 4x its share in March and just shy of its historical average of ~15%. Probably most emblematic of the extent to which market conditions have sharply inflected over the past two months was the deal brought by U.S. Steel. The integrated steel producer, whose senior unsecured bonds were trading as low as 40 cents on the dollar in February, marketed a ~$1bn 5-year first lien secured note at 8.375% to overwhelming investor demand. Despite the revival, activity still meaningfully lagged the past couple of years' pace, as volumes totaling $83.5bn year-to-date compared with$133.3bn priced over the same period last year (-37% y/y).

High Yield Net Supply (U.S.$mm)

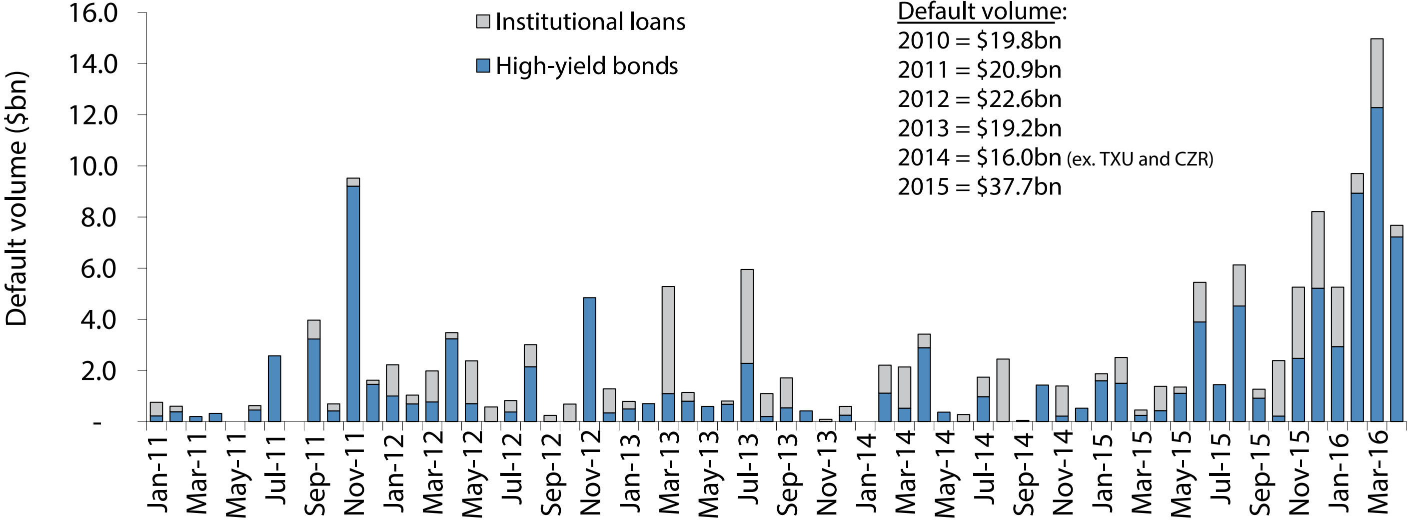
Monthly	New Issue	Redemptions	Net Supply	Monthly Returns
4/30/15	34,331	33,253	1,078	1.21%
5/31/15	33,551	29,863	3,688	0.30%
6/30/15	20,781	21,828	(1,047)	-1.49%
7/31/15	12,120	26,654	(14,534)	-0.58%
8/31/15	10,141	21,507	(11,366)	-1.74%
9/30/15	19,171	12,492	6,679	-2.45%
10/31/15	9,106	14,504	(5,398)	2.75%
11/30/15	23,014	20,435	2,579	-2.22%
12/31/15	3,077	28,406	(25,329)	-2.52%
1/31/16	5,923	12,449	(6,526)	-1.61%
2/29/16	7,557	15,556	(7,999)	0.57%
3/31/16	18,226	12,920	5,306	4.44%
4/30/16	31,176	18,454	12,722	3.92%

Source: Barclay's

Fundamental Trends

Seven companies defaulted in April representing $7.7bn of notional debt, extending the recent pick-up in default activity to a sixth consecutive month. Year-to-date 27 companies have defaulted with the volume of defaulted paper, $37.6bn, only ~$100mn shy of the total volume for all of 2015. Defaults remain largely confined to issuers in commodity-linked sectors (~85% of YTD 2016 default activity), with evidence of contagion to other corners of the economy limited for the time being (3.68% overall default rate through April, but only 0.42% ex-commodities), though the risk is considerably heightened as we near the end of this credit cycle.

Evidence of Late Cycle Behavior as Defaults Continue

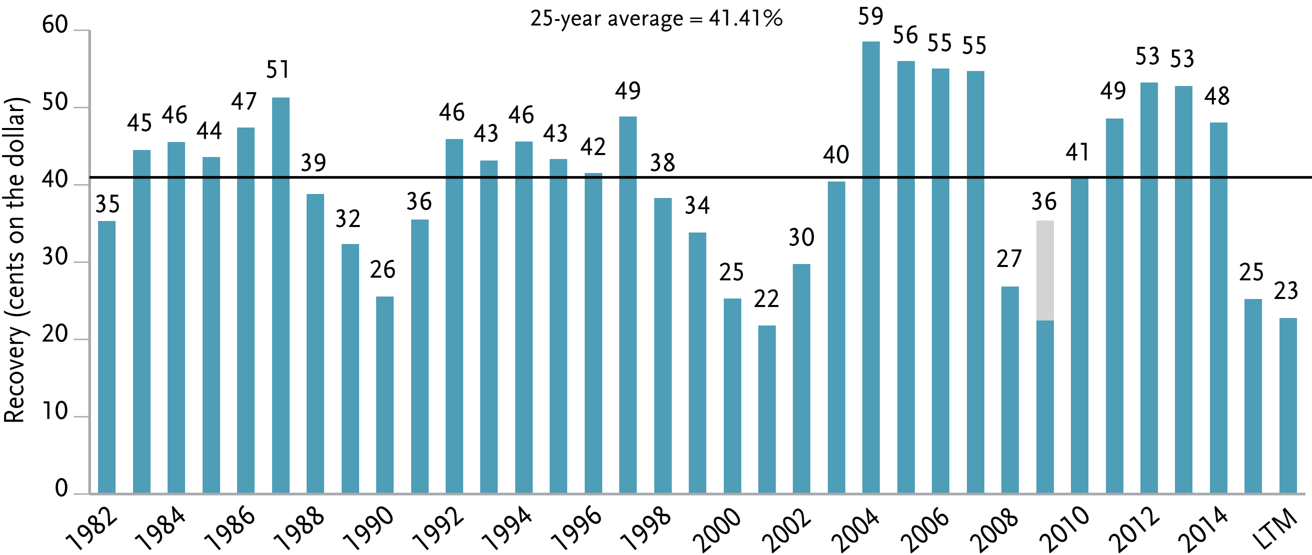


Source: JP Morgan

Note: Excludes the record setting defaults of Energy Futures' $36bn default in April 2014 and Caesar's $18bn default in December 2014.

Default rates, however, are just one variable into the calculus of determining a reasonable rate of return on an investment in levered assets. Equally as important, and arguably more worrisome today, are recovery rates, which have dropped to near all-time lows. Clearly, the combination of steadily rising defaults and greater losses given default (i.e. lower recoveries) argues for higher risk premiums and hence our distaste for the stingier yields offered on the riskiest parts of the high yield market today.

HY Bond Recovery Rates



Source: JP Morgan

Summary

While we remember our spring flings with fondness, the fact is the seasons are changing, both in terms of the calendar as well as our own maturity, and therefore we advise acting with greater prudence as we move forward. We believe we are in the late stage, or may have even passed the last leg of this spring fling, and we note that bad things tend to happen if you hold on to a casual relationship longer than you're supposed to. ■

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